BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HENRY E. AND MARJORIE E. WOHLER)

For Appellants: A. Homer Bhrad
Bookkeeper

For Respondent: Kathleen M. Morris
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Henry E. and Marjorie E. Wohler against a proposed assessment of additional personal income tax in the amount of $3,486.42 for the year 1979.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

This appeal involves the formation of two alleged partnerships between appellants and two separate California corporations.

On or about November 1, 1974, appellants, Henry E. and Marjorie E. Wohler, loaned $20,000 to New Mission Pharmacy, Inc., as part of a written financing plan entitled "Joint Venture Agreement." The loan was for a five-year term at a rate of 10 percent simple interest per annum. The loan was to be amortized on a monthly basis. Under the agreement, a second couple was to loan New Mission Pharmacy another $20,000 and enjoy the same benefits as appellants outlined below.

The agreement called for a sharing of the profits and losses of the company with the lenders by the following percentages: appellants, 44 percent; the other couple, 55 percent; and the corporation, 1 'percent. The loan was secured by the fixtures and inventory of the corporation. Appellants were also given the option to convert the loan into common stock. The stated purpose of the agreement was "to insure'the continued viability of the company [New Mission Pharmacy, Inc.], and to enable said company to effectively become a very profitable enterprise." (Resp. Br., Ex. D.) Finally, the company was given the option to repay the loan in full prior to maturity without incurring any penalties.

Appellants did not contribute more than the initial $20,000 to this venture. New Mission Pharmacy operated at a loss from the inception of the agreement through the year at issue. Each year's losses were apportioned according to the joint venture agreement and appellants claimed all or part of their apportioned loss on their personal tax returns for that year. On their income tax returns since at least 1977, appellants reported their purported "distributive shares" of New Mission Pharmacy's yearly losses as a 'partnership" loss. Although allocated $11,299 as their share of the 1979 income year's losses, appellants only reported $8,988 on their personal income tax returns. Presumably the lesser amount was used because that was all appellants needed to eliminate any income tax liability for that year.

On or about July 1, 1978, appellants entered into a separate agreement with a corporation named Rodrigues, Inc., an accountancy corporation. From this. writing entitled "Guarantee Agreement" appellants were to guarantee "any loan to Rodrigues, Inc., by any lending institution." (Resp. Br., Ex. A.) To secure their guarantee, appellants were required to place $40,000 with the lender. In exchange for this guarantee,, appellants were to share in the profits and/or losses of the company as well as the investment tax credits of Rodrigues in the following proportions: 10 percent of the profits, 90 percent of the losses, and 100 percent of the investment tax credits.

By the terms of the guarantee, Rodrigues was limited to a total indebtedness of $250,000 at any one time. Finally, as with the joint venture, the stated purpose of the guarantee was to "insure the continued viability of the company [Rodrigues, Inc.] and to enable said company to effectively become a very profitable enterprise." (Resp. Br., Ex. A.)

Appellants were not shareholders of Rodrigues, Inc., and the guarantee was appellants' only relationship with that corporation. Rodrigues operated at a loss for 1978 and 1979. Appellants were allocated $30,868 of Rodrigues' income year operating loss for 1979, which appellants reported on their personal income tax return for 1979 as a "partnership loss."

Respondent audited appellants' personal income tax returns for 1978 and 1979 and determined that the claimed "partnership losses" were actually proportionate shares of the operating losses of the two corporations. As California law does not allow an individual to deduct corporate losses, respondent accordingly disallowed the claimed "partnership" losses for 1979.

On appeal, appellants argue that the two agreements in question formed two separate general partnerships. Therefore, appellants contend, they should be allowed to deduct "partnership" losses.

Appellants' position is untenable. Clearly, neither agreement can be construed as forming a partnership.' A partnership is a distinct entity which California law defines as "an association of two or more persons to carry on as co-owners a business for profit." (Corp. Code, § 15006(l).) There are three factors vital to a determination that a business entity is a partnership: co-ownership in the assets and liabilities of the business; the right to participate in its profits and losses; and, some degree of management and control over the business. (Constans v. Ross, 106 Cal.App.2d 381 [235 P.2d 113] (1951).) Participation by all partners "in the management of a business is a primary element in [a general] partnership['s] organization, and it is virtually essential to a determination that such a relationship existed." (Dickenson v. Samples, 104 Cal.App.2d 311, 315 [231 P.2d 530] (1951).) "A mere sharing in the profits [or losses] ... does not justify an inference of partnership." (Dickenson v. Samples, supra.

As stated by respondent, no new business was created by either agreement. These corporations engaged in business on their own behalf before either agreement was entered into and were qualified state and federal corporations through the appeal year. While both agreements provide for profit and loss sharing, nothing on the face of either document reveals an intent to give appellants any ownership rights in or management control over either ongoing business. On their face, both writings are simply financial contracts.. Further, other than sharing corporate losses, neither "partnership" even attempted to observe any of the other partnership requirements.

These agreements were simply shams formulated to allow appellants to share in corporate losses as tax shelters. To argue that either agreement formed a partnership borders on the frivolous. Respondent's action in this matter will be sustained.

Appeal of Henry E. and Marjorie E. Wohler

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Henry E. and Marjorie E. Wohler against a proposed assessment of additional personal income tax in the amount of $3,486.42 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 25th day of June, 1985, by the State. Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

_______________, Member